# Thornburg Income & U.S. Government Bonds

**Portfolio Manager Commentary**
**30 June 2022**

Thornburg

## Market Review

Weighed down by a litany of concerns, the fixed income markets experienced one of the worst quarters on record. The list of investor worries going into the second half of the year is lengthy: rampant inflation, hawkish global central bank policy, rate hikes, quantitative tightening, the war in Ukraine, energy costs, slowing economic growth and a potentially looming recession. Yields across nearly every fixed income asset class were up substantially during the quarter as the U.S. Federal Reserve set the pace for other global central banks by hiking the Fed Funds rate in increasing increments in March (+25bps), May (+50bps) and June (+75bps). Spurred by monthly CPI data in May that was worse than expected, June marked the first 75bps hike since 1994 and served as a confirmation that inflation was become entrenched in the U.S. The same week in June the Swiss National Bank hiked rates (+50bps) for the first time in 15 years, as did Brazil's central bank (+50bps), and the Bank of England (+50bps). The data dependent decision-making process at global central banks, akin to driving by looking in the rearview mirror, has left many behind the curve on interest rate policy which has contributed to inflation rising to 40-year highs. As central banks now play catch-up, investors are faced with the likelihood of a not-so-soft landing, and the realization has set in that the recession many feared at the end of 2019 was not avoided by massive fiscal and monetary stimulus, but instead was only delayed.

Global rate hikes left fixed income investors with no place to hide as bonds sold off along with what felt like every other financial asset during the quarter. Longer duration bonds bore the brunt of the selloff with some debt markets down double digits on the quarter and many down over 20% on a year-to-date basis. The yield on the 10-year U.S. Treasury, which began the quarter at 2.35%, rose to 3.48%, which marked the highest level since February 2011, but managed to pare its losses in the final weeks of June to finish at 3.01%. Global sovereign debt broadly experienced a similar fate as yields on 10-year debt government rose by as much as 120bps in Brazil or as modestly as 7bps in Japan. Rates hikes also took their toll on investment-grade corporates and securitized debt, which were both down substantially for the quarter and for the year. Credit sectors such as U.S. and global high yield corporates also had to contend with recession concerns, igniting a flight to quality that led credit spreads to widen by a couple of hundred basis points during the quarter thus, further compounding losses created by rate movements. The waning weeks of the quarter were surprisingly unlike the previous two months as yields fell following the Fed's June rate hike. Restored credibility in the Fed's willingness and ability to fight inflation, coupled with a looming economic slowdown, led investors to reignite a bid for Treasuries given the ability to purchase bonds at multi-year high yield levels.

> We are taking advantage of volatility to pursue attractive opportunities within fixed income.

## Portfolio Managers


**Jason Brady, CFA**
President and CEO
Portfolio Manager

**Lon Erickson, CFA**
Portfolio Manager

**Jeff Klingelhofer, CFA**
Co-Head of Investments
Portfolio Manager

Supported by the entire Thornburg investment team

## Performance Summary

- The Thornburg Limited Term Income Strategy composite returned -2.52% (net of fees) during the second quarter, modestly underperforming the Bloomberg Intermediate Government/Credit Index, which returned -2.37% (net of fees).
- The strategy's structural short duration position versus the index was a contributor to relative performance. The 5-year U.S. Treasury yield moved higher by 58 bps to end the quarter at 3.04%, while the 10-year Treasury yield ended the period 68 bps higher at 3.01%. Curve positioning was an additional contributor given the strategy's relative shorter maturity profile. As referenced above, rates on the front end of the curve rose less than its longer maturity counterparts.
- Despite the strategy's defensive posture, the allocation to spread sectors ultimately detracted from relative performance, though no one sector was a significant detractor. Exposure to asset-backed securities lagged in sympathy with other risk assets. A steady supply of deals coming to market ensured that technicals remained weak in the asset-backed space during the second quarter. Collateralized mortgage obligation exposure proved to be a detractor as investor demand for mortgage credit continued to wane during the second quarter. Finally, investment grade corporates detracted, as the Bloomberg Investment Grade Corporate Index meaningfully widening from 116 bps to 155 bps.

### Limited Term Income Strategy Average Annual Returns (%, as of 30 Jun 2022)

In US$ terms. Returns may increase or decrease as a result of currency fluctuations.

| | QTR | YTD | 1-YR | 3-YR | 5-YR | 10-YR |
|---|---|---|---|---|---|---|
| **Limited Term Income Composite* (Net)** | -2.59 | -6.22 | -6.43 | 0.72 | 1.72 | 2.33 |
| **Limited Term Income Composite (Gross)** | -2.52 | -6.07 | -6.14 | 1.04 | 2.05 | 2.68 |
| **BBG Int US Govt/Credit TR Value** | -2.37 | -6.77 | -7.28 | -0.16 | 1.13 | 1.45 |

### Limited Term US Government Strategy Average Annual Returns (%, as of 30 Jun 2022)

In US$ terms. Returns may increase or decrease as a result of currency fluctuations.

| | QTR | YTD | 1-YR | 3-YR | 5-YR | 10-YR |
|---|---|---|---|---|---|---|
| **Limited Term U.S. Government Composite (Net)** | -1.95 | -5.39 | -5.68 | -0.53 | 0.62 | 0.90 |
| **Limited Term U.S. Government Composite (Gross)** | -1.86 | -5.21 | -5.32 | -0.16 | 1.00 | 1.28 |
| **BBG Barclays US Govt Int TR Value** | -1.65 | -5.77 | -6.32 | -0.30 | 0.87 | 0.97 |

*Performance data for the Limited Term Income Strategy is from the Limited Term Income Composite, inception date of 1 February 1993. The Limited Term Income Composite includes all non-wrap discretionary accounts invested in the Limited Term Income Strategy. Returns reflect the reinvestment of income and capital gains. Performance data for the Limited Term U.S. Government Strategy is from the Limited Term U.S. Government Composite, inception date of 1 March 1988. The Limited Term U.S. Government Composite includes all discretionary non-wrap accounts invested in the Limited Term U.S. Government Strategy. Returns reflect the reinvestment of income and capital gains.

*Each composite represents all assets under management in fully discretionary, transaction fee based accounts. Returns are calculated using a time-weighted and asset-weighted calculation including reinvestment of dividends and income. Periods less than one year are not annualized. Individual account performance will vary. The performance data quoted represents past performance; it does not guarantee future results. Net of fee returns are net of transaction costs and investment advisory fees. For periods prior to 2011, net returns for some accounts in the composite also reflect the deduction of administrative expenses. Thornburg Investment Management Inc.'s fee schedule is detailed in Part 2A of its ADV brochure. Gross of fee returns are net of transaction costs. Performance results of the firm's clients will be reduced by the firm's management fees. For example, an account with a compounded annual total return of 10% would have increased by 159% over ten years. Assuming an annual management fee of 0.75%, this increase would be 142%.*

### Annual Return Performance Summary

| | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **Limited Term Income Composite (Net)** | 5.56 | 7.95 | 0.39 | 3.89 | 0.98 | 3.63 | 2.89 | 1.38 | 5.91 | 7.74 | -0.64 |
| **Limited Term Income Composite (Gross)** | 6.05 | 8.41 | 0.77 | 4.28 | 1.34 | 3.99 | 3.22 | 1.72 | 6.26 | 8.09 | -0.33 |
| **BBG Barclays Int US Govt/Credit TR Value** | 5.80 | 3.89 | -0.86 | 3.13 | 1.07 | 2.08 | 2.14 | 0.88 | 6.80 | 6.43 | -1.44 |
| **Limited Term U.S. Government Composite (Net)** | 4.35 | 2.53 | -1.37 | 2.86 | 0.81 | 1.52 | 1.16 | 1.33 | 4.16 | 4.31 | -1.35 |
| **Limited Term Term U.S. Government Composite (Gross)** | 4.74 | 2.92 | -1.00 | 3.25 | 1.20 | 1.90 | 1.53 | 1.71 | 4.55 | 4.69 | -0.99 |
| **BBG Barclays US Govt Int TR Value** | 6.08 | 1.73 | -1.25 | 2.52 | 1.18 | 1.05 | 1.14 | 1.43 | 5.20 | 5.73 | -1.69 |

*Past performance does not guarantee future results.*

## Positioning and Outlook

With central banks in full inflation fighting mode, the chances of recession have risen rapidly, with the question becoming not if a recession will occur, but potentially how deep it might be. Central banks have a mixed record at best with soft landings, and the Fed is reluctant to admit that some sort of demand contraction is needed to soften inflation. Given this backdrop, portfolio risk continues to be defensively positioned. We incrementally added duration as rates have risen, believing Treasury yields have reached a level somewhat close to fair value, though tail risks remain elevated on both sides. A Fed unable to control inflation and inflation expectations is a recipe for rapidly rising rates. On the flip side, recession fears may well reignite an interest rate rally as investors once again look to Treasuries as a safe haven in times of stress.

Securitized fixed income remains the best relative value proposition in the portfolio. We are constructive on spread levels and favor a bias toward prime consumer issuance. That said, we believe the portfolio has an appropriate level of securitized risk, mindful that spreads could widen further in a risk-off environment. Though recession and inflation fears will remain an overhang, the consumer is broadly coming into the second half of the year in a position of strength. Delinquencies across prime consumer sectors are modestly higher than in 2020-2021, but remain low overall, and in many cases, still below pre-COVID levels. We continue to be cautious on the subprime consumer, given the challenges this cohort could experience should the economy drastically weaken. Within the residential mortgage space, the headwind of rising mortgage rates is being offset by still favorable supply/demand dynamics. While we expect housing market strength to wane, bondholders have plenty of built in protection from lower LTVs and existing loans underwritten with strong lending standards.

Within U.S. corporates, valuations have improved to a point that, as of quarter-end, spreads are clearly above long-term historical averages. While this makes the opportunity set within corporates more interesting, we remain fairly cautious given the weakening macro backdrop and input cost inflation. We have a bias toward names with less cyclicality and more attractive valuations versus recent history. We are cautious on bank loans both on relative value versus high yield as well as a broadly asymmetric risk/return tradeoff. In emerging markets, weakness persists in sympathy with broader risky assets and the weak growth/high inflation narrative. We believe this environment has created security-level mispricing for which we will look to exploit. The timing, however, will be based on evolving domestic and global trends. We continue to look for opportunities in areas with high real rates, advanced policy cycles, and improving domestic demand.

Thanks for your continued support and investing alongside us in Thornburg's fixed income funds.

## Important Information

*The performance data quoted represents past performance; it does not guarantee future results.*

Unless otherwise noted, the source of all data, charts, tables and graphs is Thornburg Investment Management, Inc., as of 30 June 2022.

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Holdings may change daily and may vary among accounts.

U.S. Treasury securities, such as bills, notes and bonds, are negotiable debt obligations of the U.S. government. These debt obligations are backed by the "full faith and credit" of the government and issued at various schedules and maturities. Income from Treasury securities is exempt from state and local, but not federal, taxes.

Portfolios investing in bonds have the same interest rate, inflation, and credit risks that are associated with the underlying bonds. The value of bonds will fluctuate relative to changes in interest rates, decreasing when interest rates rise.

The Bloomberg Intermediate US Government/Credit Total Return Index Value Unhedged is an unmanaged, market-weighted index generally representative of intermediate government and investment-grade corporate debt securities having maturities from one up to ten years.

The Bloomberg US Government Intermediate Total Return Index Value Unhedged is an unmanaged, market-weighted index generally representative of all public obligations of the U.S. Government, its agencies and instrumentalities having maturities from one up to ten years.

The Bloomberg U.S. Corporate Bond Investment Grade Index is publicly issued U.S. corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity, and quality requirements. To qualify, bonds must be SEC-registered.

Portfolio construction will have significant differences from that of a benchmark index in terms of security holdings, industry weightings, asset allocations and number of positions held, all of which may contribute to performance, characteristics and volatility differences. Investors may not make direct investments into any index.

Asset-backed Security (ABS) - A security whose value and income payments are derived from and collateralized (or "backed") by a specified pool of underlying assets. The pool of assets is typically a group of small and illiquid assets that are unable to be sold individually. Pooling the assets into financial instruments allows them to be sold to general investors, a process called securitization, and allows the risk of investing in the underlying assets to be diversified because each security will represent a fraction of the total value of the diverse pool of underlying assets.

Basis Point (bp) - A unit equal to 1/100th of 1%. 1% = 100 basis points (bps).

A bond credit rating assesses the financial ability of a debt issuer to make timely payments of principal and interest. Ratings of AAA (the highest), AA, A, and BBB are investment-grade quality. Ratings of BB, B, CCC, CC, C and D (the lowest) are considered below investment grade, speculative grade, or junk bonds.

Credit Spread/Quality Spread - The difference between the yields of securities with different credit qualities.

Duration - A bond's sensitivity to interest rates. Bonds with longer durations experience greater price volatility than bonds with shorter durations.

Mortgage-backed Security - A type of asset-backed security that is secured by a mortgage or collection of mortgages. These securities must be grouped in one of the top two ratings as determined by a accredited credit rating agency and usually pay periodic payments that are similar to coupon payments. The mortgage must have originated from a regulated and authorized financial institution.

Mortgage Pass-Through - A security consisting of a pool of residential mortgage loans. Payments of principal, interest and prepayments are "passed through" to investors each month.

Yield Curve - A line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates.

Yield to Worst (YTW) - The lowest potential yield that can be received on a bond without the issuer actually defaulting.

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